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Transition to a Market Economy: Lessons from the IMF's Experience

When he went to Poland in June 1989, Ved P. Gandhi, Assistant Director in the IMF's Fiscal Affairs Department, said, "I went as a student to learn as quickly as I could about centrally planned economies (CPEs). When I went back in November of the same year, I went as adviser to a government in the process of transition to a market economy." Thus did Gandhi describe the challenge confronting many of the formerly centrally planned economies of Eastern Europe that suddenly found themselves speeding down an unmapped superhighway en route to a market-based economy.

Gandhi was speaking at a seminar held at the IMF Visitors' Center on July 8, entitled "Transition to Market," featuring the experience of the IMF's Fiscal Affairs Department in advising countries in the process of moving from centrally planned to market economies. As moderator Vito Tanzi, Director of the Fiscal Affairs Department, explained, when the rush toward transformation began in late 1989, "we were not very well prepared for this kind of work; people had worked on developing countries but with other kinds of economies; but they did not know much about the CPEs, especially about the problems that arise during the transition."

According to Tanzi, while providing technical assistance to these countries in transition, the Fund amassed considerable practical experience. The fruits of this experience have been collected in two volumes, both edited by Tanzi—*Fiscal Policies in Economies in Transition*, which was published last year, and the recently published *Transition to Market*. "These books," said Tanzi, "have played a very important role in assisting people who go to the country and have to face problems they have never faced before."

Chu: Social safety nets strengthen the political viability of the program.

Securing the Safety Net

A problem common to all transition economies is how to insulate the population in the *(Please turn to page 237)*

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IMF Seminar Measures Impact of Russian Price Liberalization

In discussions of Russia, the tendency has been to theorize first and look for data later, observed Vincent Koen, an Economist in the IMF's European II Department. Hard data have, admittedly, proved difficult to find, but an increasing flow of information suggests that quantified analysis may be both practicable and useful in illuminating the determinants of Russia's economic transformation. One of the first such studies to emerge from the IMF—an analysis of Russia's experience with price liberalization—formed the basis of a June 10 seminar in the IMF Visitors' Center.

Highlighting the research of Koen and Steven Phillips, an Economist in the IMF's Policy Development and Review Department, and the commentary of John Williamson, Senior Fellow at the Institute for International Economics, the discussion concentrated on the behavior of prices, household incomes, and consumption during 1992—the first year of Russia's efforts to liberalize prices.

Background

To assess the impact of Russia's price liberalization, Koen and Phillips needed to measure 1992 against a typical earlier year. They rejected 1991 as a suitable benchmark because that year marked the culmination of large macroeconomic disequilibria that had built up through the late 1980s. A more reasonable benchmark, in their view, would be 1987—the most recent year before wage and output developments began to diverge markedly. To provide another point of reference, they also contrasted Russia's experience with that of the Central and Eastern European economies that had embarked on the transition one or two years earlier.

Russia's nominal wages rose dramatically in the late 1980s, while the rate of output growth declined and then turned sharply negative. With prices remaining largely fixed, shortages worsened, ultimately leading to a loss of effective control over pricing behavior. Major price adjustments appeared inevitable, but Russia's efforts in early 1991, which combined administrative increases with a partial price liberalization, had little impact. In late October 1991, in the context of accelerating inflation, President Boris Yeltsin announced a comprehensive price liberalization, which took effect on January 2, 1992.

Koen: Russia's large monetary overhang probably accounted for the magnitude of price increases.

In value terms and at 1991 relative prices, Russia's liberalization freed 80 percent of producer prices and 90 percent of consumer prices. Although controls remained on electricity, fuels, precious metals, certain basic food items, and rents, most prices, in effect, were liberalized.

Price Developments

Upon liberalization, consumer prices quadrupled and producer prices quintupled. (Interestingly, prices in city markets, which were traditionally free of controls, rose by only about 50 percent.) Russia's price jump was "much larger than any observed in Central or Eastern Europe," Koen emphasized, "where the highest increase had been a 123 percent jump in Bulgaria's consumer prices." The obvious and critical question was Why?

Koen posited three possible explanations, but concluded that only one—Russia's larger monetary overhang—could have possibly accounted for the magnitude of the price increases.

• ***Expectations.*** In late 1991 Russian government officials publicly announced that they expected liberalization to increase prices several times over. Indeed, a number of key administered prices were raised three-to-five fold on January 2. There is some speculation that the Government's preliberalization announcement may have acted as an unintended coordination device for price setters.

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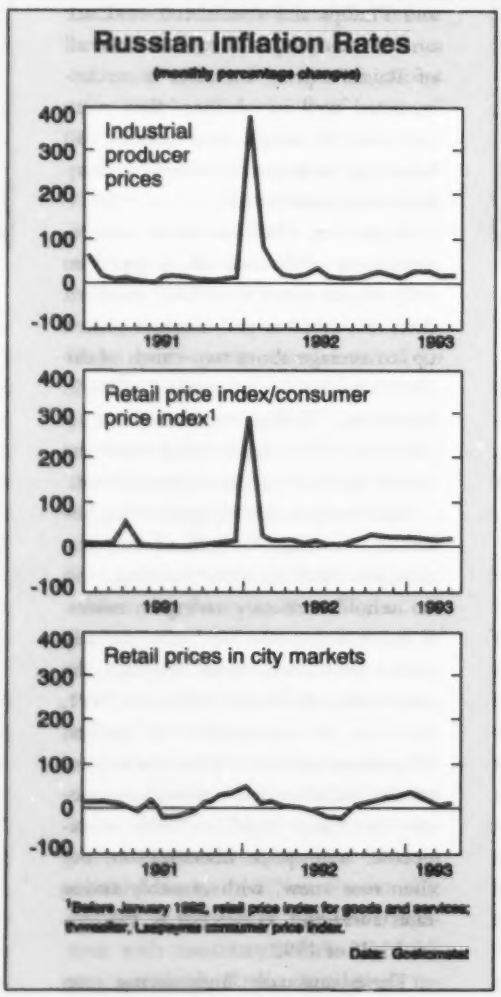
• ***Introduction of Value-Added Tax (VAT).*** In conjunction with the price liberalization, Russia replaced its sales and turnover taxes with a 28 percent VAT. Although the rate is very high, it explains only a fraction of the price jump.

• ***Monetary Overhang.*** Evidence suggests that Russia's monetary overhang was much larger than that of other Central and Eastern European countries and was similar to that which existed in Poland before liberalization. However, Poland partially liberalized prices in the summer of 1989, Koen explained, and this liberalization absorbed a substantial part of its overhang before Poland's 'big bang' of January 1990. Energy prices, which had long been kept relatively low in Russia, were among the administered prices raised in January 1992. The initial price adjustment, however, barely exceeded the jump in other prices. Following a further administrative price increase in May and a quasi-deregulation in September, the relative domestic price of oil increased significantly. Prices for natural gas and coal remained extremely low, however.

One of the curious aspects of Russia's experience with price liberalization was that producer prices rose two-and-a-half times faster than consumer prices in the first half of 1992. Koen linked this divergence to an exponential increase in enterprise arrears during the period. With settlement often delayed by several months, enterprises tended to build expected inflation into contract prices. In the absence of hard budget constraints on enterprises, arrears accumulated rapidly, until the introduction of a prepayment rule and the relaxation of financial policies around mid-1992 began to slow the pace. Final demand limitations, by contrast, affected prices in the cash-driven market for consumer goods more directly and prevented them from rising in line with producer prices.

Although one of the principal objectives of price liberalization is to eliminate or reduce shortages and queues, measuring shortages, Koen noted, is often difficult. In Russia's case, the study used the availability of goods in monitored urban state stores as a proxy for country-wide availability. The monitored sites reflected a dramatic decline in shortages for most goods, although acute shortages and panic buying continued to characterize the supply of such items as sugar and vegetable oil through 1992.

Koen concluded that a major question was whether price liberalization had engendered an output response. Early evidence indeed suggested a shift in the output mix.



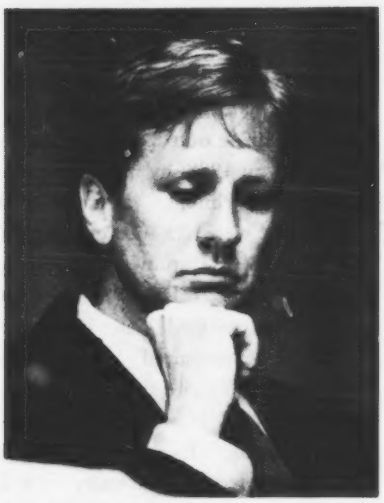
Household Income, Expenditure, and Savings

Wages began to outpace prices significantly in 1988; by mid-1990, observed Phillips, average real wages were 25 percent higher than in the study's benchmark year, 1987. In late 1991, in what Phillips termed "an incredible spike," measured real wages jumped to more than twice their 1987 level. From this clearly unsustainable level, real wages plummeted in January 1992 when prices were liberalized. They recovered later in 1992, however, and now approximate the 1987 benchmark level.

Statistical evidence of a recovery in real wages seems to contradict widespread impressions that Russia has experienced a very substantial decline in living standards. Although wages have recovered from their January 1992 low, the wage data may, for a number of reasons, overestimate the standard of living, Phillips cautioned. For example, they reflect neither wage arrears, which were an important factor through at least the first half of 1992, nor the inflation tax on households.

The study also examines whether the real wage level achieved in the post-liberalization period is sustainable. The key question—and the study notes

much disagreement on this topic—is whether the wage levels of the mid-1980s were appropriate or whether they already reflected a disequilibrium. If 1987 is an appropriate benchmark, Phillips said, then the significant decline in productivity since that time may point to the need for yet another cut in real wages. But he also speculated that it might be possible to increase the share of labor in Russia's national income if public absorption declines and private consumption is given room to expand.



Phillips: Russia's experience has contrasted sharply with that of other Central and Eastern European countries.

Russia's experience is interesting, Phillips noted, because it contrasted sharply with that of other Central and Eastern European countries. In most of these economies, real wage buildups were much smaller than in Russia, and the former Czechoslovakia had virtually no buildup at all. But in these countries, real wages fell steeply with price reform. Russia's experience most closely approximated Poland's, the study found, although only in Russia has the real wage apparently recovered to its 1987 level.

Phillips noted that Russia opted for a relatively weak form of incomes policy, imposing on wages four times higher than the minimum wage a profit tax that cannot be regarded as prohibitive. But the country's monetary and fiscal policies were not consistent with low inflation, he added, and its incomes policy was "probably doomed to fail as a supplementary nominal anchor, given the state of other policies."

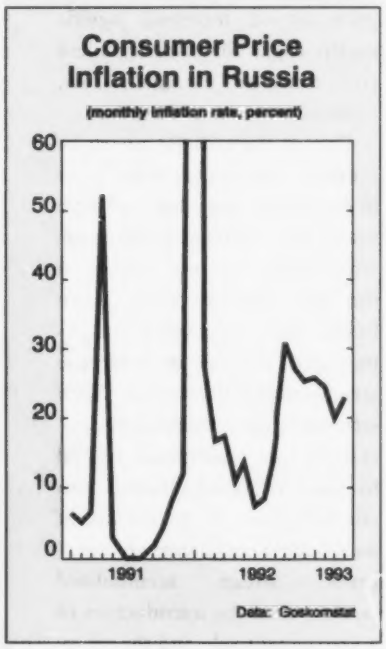
Before price reform, Phillips emphasized, measured levels of real wages and incomes proved a poor indicator of consumer welfare because money was often not readily convertible into purchases in the pre-1992 "shortage economy." To draw a more accurate assessment of consumer welfare, Koen and Phillips also considered evidence on consumer expenditures. Because all of Russia's price increases were announced well in advance, they were preceded by surges in purchases and hoarding behavior, followed by sharp drops in expenditures.

In January 1992, measured real expenditures of households dropped to only 40 percent of their 1987 level but then recovered as real incomes picked up, to average about two-thirds of the 1987 level by the last quarter of 1992. However, Phillips cautioned, it is likely that these figures understate the actual level of consumer expenditure.

The study also examined saving behavior, focusing (for lack of information on hard currency holdings) on household monetary saving in rubles. Russia's saving rate had been relatively stable for twenty years, through the mid-1980s. Between 1985 and 1991, however, it quintupled; it reached 25 percent in mid-1991, reflecting repressed inflation and a growing monetary overhang. It fell in 1992, as expected, with price liberalization, but then rose anew, with monthly saving rates averaging 35 percent in the second half of 1992.

These unusually high saving rates were, the study argues, probably tied to unusually high inflation rates. "If Russia was the outlier among transition economies as far as saving rates," Phillips noted, "it was also the outlier as far as inflation is concerned. This is consistent with the fact that high inflation, other things being equal, would imply a greater inflation tax on household balances."

After a very sharp drop in the first quarter of 1992, real household balances appeared to stabilize in the second quarter but still represented only 20 percent of their 1987 level during the remainder of 1992. The study suggests two possible explanations: the more controversial is that there may have been excess real balances and a monetary overhang already in 1987; the second is that the levels of real ruble balances may have fallen off in 1992 as Russians tried to partially escape the inflation tax present in 1992 but absent in 1987. Phillips observed that even when inflation was least



rapid—in the third quarter of 1992—households would have had to save 20 percent of their disposable income just to maintain the real value of their ruble savings. In the fourth quarter, they would have had to save 50 percent, and in fact saved about 35 percent. Available returns on ruble-denominated assets were very low,

Williamson: Suggestions that Russia could suddenly be "unshocked" are rubbish.

offering households little shelter from the inflation tax.

All indicators also pointed to a widening gap in the distribution of income in 1991. "The ratio of average per capita income of the highest decile of the population to the average per capita in the lowest decile rose from a little over five times in 1991 to almost nine times by December 1992," Phillips noted. A large part of this widening spread could be accounted for by an increasing dispersion of wage income, with higher wage sectors tending to experience faster wage growth. Another explanation is that nonwage income, notably pensions, appeared not to keep up with wage growth. Phillips also observed that the end of shortages in Russia may not have affected the population uniformly. Before price liberalization, pensioners and others who may have had more time to wait in lines were probably relatively better off than their money incomes suggested. With price liberalization, he added, "money has become more important than time as a means of obtaining goods."

Commentary

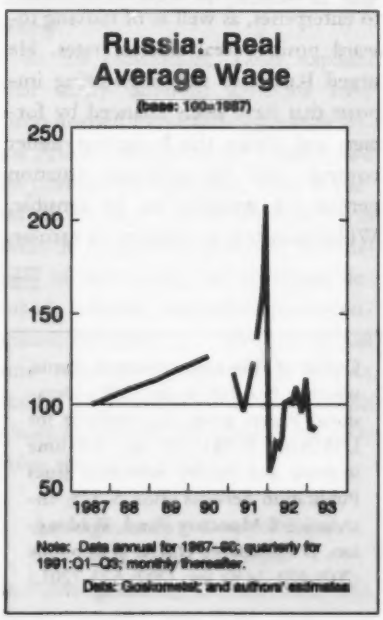
Williamson opened his remarks on the Koen-Phillips paper by quoting from a recent analysis of Russia's experience by the Institute of Economic Problems in Transitional Periods, headed by former Russian Prime Minister Yegor Gaidar. The paper argued that Russia had been confronted with a choice between alternative shocks, not a choice of whether or not to accept these shocks. "I find myself gasping," Williamson said, "when I sometimes read in Western newspapers that shock therapy is about to collapse, as though Russia could suddenly be unshocked and go back to where it was in November 1991. That is rubbish."

Discussing the reasons for the much larger price jump that occurred in Russia, Williamson minimized the impact of the Government's announcement of price increases and stressed the importance of a very large monetary overhang. "If you are looking at a sophisticated economy like the United States, you give very little weight to monetarist theories. But if you are looking at a very extreme situation of monetary disequilibrium, that is what you look at. It is by far the best explanation."

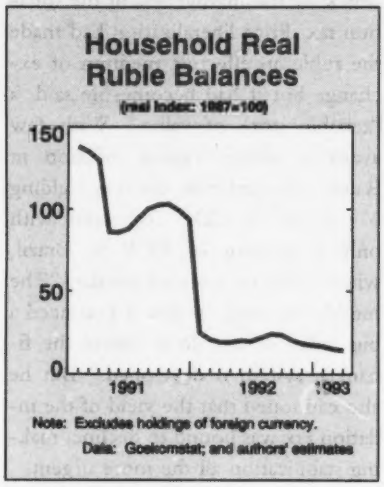
Commenting on subsequent inflation in Russia, Williamson noted that it has remained high, verging on hyperinflation. He speculated that it would have seemed "more reasonable to have accompanied price liberalization with monetary reform. But this was not done. Russia decided to inflate away the monetary overhang, and that was duly accomplished." Inflation fell for six months under relatively tight macroeconomic policies, then the policy stance started to loosen. "The Russian authorities reportedly thought that this had to be done because they felt no constituency existed to maintain tough policies," he said.

Williamson added that he was struck by the massiveness of the inflation tax. Price liberalization had made the ruble an effective medium of exchange but it had become, he said, a "terrible store of value." With few available hedges against inflation in Russia, the inflation tax was yielding 6 percent of GDP compared with only 2 percent of GDP in Brazil, where inflation rates are similar. "The moral," he said, "is that if you need a big inflation tax, do it before the financial system is developed." But he also cautioned that the yield of the inflation tax was bound to decline, making stabilization all the more urgent.

Williamson concluded his remarks



with a series of recommendations that follow, he said, traditional IMF prescriptions. He called for an improvement in tax administration, an indexation of tax obligations, and the development of new sources of revenue. He noted the importance of stringent expenditure controls but cautioned against "overdoing" these.



He cited the necessity of reining in the central bank and controlling credit to enterprises, as well as of moving toward positive real interest rates. He urged Russia to stop subsidizing imports that have been financed by foreign aid. Once the budget is under control, and the political situation permits, it would then be sensible, Williamson felt, to stabilize in earnest.

Copies of *Price Liberalization in Russia*, which is No. 104 in the IMF's Occasional Papers series, are available for US$15.00 (US$12.00 for full-time students and faculty members) from Publication Services, Box S-375, International Monetary Fund, Washington, D.C., 20431, U.S.A. (Telephone (202) 623-7430; fax: (202) 623-7201.)

Measurement of Fiscal Deficits Examined in New IMF Book

Correct measurement of the public sector's net use of resources—its fiscal deficit or surplus—is an important prerequisite for managing a country's macroeconomy, according to Mario I. Blejer and Adrienne Cheasty, editors of a book recently published by the IMF.

In their introduction to *How to Measure the Fiscal Deficit: Analytical and Methodological Issues*, Blejer and Cheasty observe that "although the deficit measure is relevant primarily as an indicator of the macroeconomic consequences of fiscal policy, the set of consequences that policymakers desire to assess may itself determine the 'correct' deficit measure. In other words, there is no such thing as *the* fiscal deficit, but rather a series of alternative measures, each with advantages and disadvantages."

The book's 16 chapters, most of which were written by economists in the IMF's Fiscal Affairs Department, discuss numerous aspects of the measurement of fiscal deficits, drawing on the experience of the IMF in the course of its work with member countries. Among the topics covered are basic issues in fiscal measurement, measurement of fiscal performance in IMF-supported programs, summary indicators of a country's fiscal policy stance, fiscal impulse measures and their fiscal impact, the cash deficit's rationale and limitations, government arrears in fiscal adjustment programs, credit subsidies in budgetary lending, and the effects of inflation on the measurement of fiscal deficits.

Also included are chapters on defining and measuring the fiscal impact of public enterprises, consolidating central banks and fiscal deficits, the impact of public financial institutions on a country's fiscal stance, the deficit as an indicator of government solvency, the budgetary impact of privatization, and the measurement of the fiscal impact of government contingent liabilities. Highlights of several of these chapters follow.

Basic Issues in Fiscal Deficit Measurement

In "Fiscal Deficit Measurement: Basic Issues," Vito Tanzi, Director of the IMF's Fiscal Affairs Department, points out that the difficult realities of the 1980s, including the debt crisis and the excess public sector demand in many economies, pushed developing countries to reduce the claims of the public sector on their economies while making efforts to improve their productive capacities.

Tanzi explains that the conventional measure of the fiscal deficit, defined as the difference between total government expenditure and government's current revenue, has three important limitations as a measure of excess demand in an economy. First, because different taxes and government expenditures have different effects on demand, and it is difficult for economists to agree on the weight to assign to each effect, precise measurement of the demand created by the public sector is problematic.

Second, it is difficult to determine the proper magnitude of fiscal adjustment that a country needs to undertake: Should it be equal to the deficit the country actually has during a given period, or should corrections be made to revenue and expenditure to reflect the stage of the business cycle the country's economy is currently in?

Third, since different ways of funding deficits—central bank financing, commercial bank financing, bond financing, foreign financing, domestic suppliers' financing, and so on—have different effects on demand, it is difficult, given a specific existing deficit, to determine the macroeconomic impact of deficit financing. Tanzi concludes that although all three types of limitations are important, the first two are likely to have little relevance for deve-loping countries. The third limitation, however, is quite relevant and "has not received the attention it deserves."

The author notes that, among others, several Italian economists have recently argued that borrowing by a country's government on behalf of public enterprises should be excluded from the deficit because such credit is not, strictly speaking, for government purposes. Tanzi takes issue with this argument, noting that "it implicitly assumes that the public enterprises would do exactly the same amount of borrowing and presumably would produce the same output at similar costs if they were private enterprises. It also assumes that they would borrow, at presumably identical conditions, regardless of the losses they might be making." He notes that these assumptions are not borne out by the behavior of many public enterprises, adding that "these enterprises survive because the government is there to provide funds, and . . . what they produce and the way they produce it are certainly influenced by their 'publicness.'"

Tanzi observes that an alternative deficit concept that has received considerable attention is the fiscal deficit on current account—the difference between government revenue and *current* government expenditure. He points out that, since it excludes capital expenditure, its proponents view it as a measure of the government's contribution to the total saving of an economy and, thus, to its economic growth. He asserts, however, that this deficit concept is seriously flawed. First, it makes no allowance for the fact that whether a government spends on current expenditure or on investment, the short-run effect of the expenditure on the country's balance of payments will be the same.

Second, noting that it disregards the fact that investment may be as wasteful as, or even more wasteful than, current expenditure, the author comments that the economic histories of many countries are "full of horror stories of highly wasteful public investment projects that, after getting a country into foreign debt, became useless white elephants." At the same time, he points out, the deficit on current account fails to incorporate the important positive effects that many current expenditures—for example, on health, education, administration, and the maintenance of infrastructure—have on long-run economic growth. Tanzi also expresses the view that "the dividing line between what is classified as current and what is classified as capital expenditure is, in the real world, an arbitrary one that can be moved up and down depending on the picture that policymakers may wish to present to the world."

In his conclusion, Tanzi explains that many different concepts have been devised to measure countries' fiscal deficits, and, of these, "each could be justified for some use; none is useful for all uses." Since, he adds, "it is difficult to measure precisely the impact of fiscal policy on aggregate demand, inflation, and other macroeconomic variables . . . . the use of just one number to assess that impact should be de-emphasized, and a much closer scrutiny of the whole fiscal situation should be made."

***Adrienne Cheasty and Mario I. Blejer, coeditors of* How to Measure the Fiscal Deficit.**

Photo credits: all photos by Denio Zara and Padraic Hughes for IMF.

Amalgamating Central Bank and Fiscal Deficits

In "Amalgamating Central Bank and Fiscal Deficits," two IMF economists

who formerly worked in the Fiscal Affairs Department—David J. Robinson of the Southeast Asia and Pacific Department and Peter Stella of the Monetary and Exchange Affairs Department—discuss some of the problems that arise in interpreting fiscal data when central banks run losses—a problem that has been experienced in quite a few developing countries, including some with relatively sophisticated financial markets. The authors point out that although the causes and macro-economic effects of central bank deficits are similar to those of deficits run by countries' central governments, the treatment of central bank deficits is currently the subject of considerable debate.

Tanzi: The use of a single number to assess the impact of fiscal policy should be de-emphasized.

Robinson and Stella draw a distinction between two types of central bank activities: purely monetary activities (those undertaken to support monetary policy) and quasi-fiscal activities, (those not specifically related to monetary policy and that would, in many other countries, be carried out by agencies of the central government). They assert that a central bank's quasi-fiscal activities, unlike its purely monetary ones, should be included in the government's accounts—and, consequently, in measures of the government's fiscal deficit—whenever they affect the central bank's profit-and-loss account.

Any quasi-fiscal activities not already included in this account should be reviewed to determine whether it would be appropriate to include them. The authors note, however, that efforts to incorporate a central bank's quasi-fiscal revenues and expenditures into the government's accounts, leaving the central bank's accounts covering only monetary activities, can create problems because of the different accounting systems used in governments and central banks. (Government accounts are on a cash basis, whereas central bank accounts are on an accrual basis.)

In a discussion of the basic elements of a central bank's accounts, Robinson and Stella observe that the way in which both quasi-fiscal revenues and expenditures are captured [in them] is often unclear. Further, some items—for example, exchange rate or loan guarantees a central bank has made—may remain completely off its balance sheet. The authors point out that when a central bank operates profitably, it generally transfers a substantial portion of its profit to the government; when it operates at a loss, however, it generally runs down its reserves (or prints money) rather than receiving a transfer from the government to cover all or part of the loss.

Such an asymmetrical accounting treatment can call into question the accuracy of measures of a country's fiscal deficit when such losses are run. The authors also point out that "unlike commercial banks, there is no reason why a central bank cannot continually make losses and have a persistently negative net worth. Therefore, unlike [those of] other public sector entities, central bank losses need not be 'funded.'" This creates a problem in assessing the impact of central bank losses. In order to address this problem, the authors suggest, "symmetry must be restored . . . . [and therefore] the impact of the entire central bank loss should be included in the government accounts, ... thereby increasing the fiscal deficit."

Additionally, the authors recommend that an estimate be made of the size of a central bank's quasi-fiscal activities falling *outside* its profit-and-loss account, pointing out that this estimate could serve as a useful supplementary indicator for analysts and policymakers. They further note that since exchange rate guarantees made by central banks may result in heavy losses for them, other supplementary indicators—showing, for example, the value of such central bank guarantees outstanding and the losses that would result if they were called at the current exchange rate—could provide further useful information.

The Deficit as an Indicator of Government Solvency

In "The Deficit as an Indicator of Government Solvency: Changes in Public Sector Net Worth," Mario I. Blejer, formerly the Chief of the IMF's Fiscal Affairs Department's Special Fiscal Studies Division and currently Assistant Director in the Monetary and Exchange Affairs Department, and Adrienne Cheasty, formerly with the Fiscal Affairs Department and currently with the European II Department, emphasize that "the government, even if infinitely lived, is constrained—like private consumers—by the size of its permanent income."

The authors note that a government's consumption is determined by both its wealth and its income. For example, in recent years, governments have used privatization programs as a means of dissaving to finance their

current consumption. They also point out that price and valuation changes in a government's assets or liabilities can significantly affect its consumption, noting that a government's ability to pay can be affected by changes in the value of its assets and liabilities (capital gains or losses), as well as by inflation, currency devaluation, and changes in its terms of trade or in relative prices. Since neither the full effects of government asset sales nor those of valuation changes are generally included in traditional measures of a country's deficit, these measures may have serious limitations as policy guides.

Blejer and Cheasty observe that the revenue derived from privatizations or other asset sales is generally included in government accounts, but the reduction in the value of the government's assets frequently is not. Employees' contributions to social insurance programs are included in revenues, but, because these commit the government to higher future spending, the resulting deficit measures will overstate the government's ability to pay. They state that "analogously, the conventional deficit can be dramatically inflated in any year by the government's payment of previously *guaranteed debt*, or insurance contracts, such as exchange guarantees or bailouts of underwritten entities (like insolvent public enterprises or the U.S. savings and loan industry)."

The authors call for a refocusing of the fiscal deficit measure to make it "an indicator of the long-run sustainability of government policy—in other words, of the solvency of government." Observing, in line with private sector consumer theory, that "although a government can shift consumption between periods by alternately saving and borrowing, it will be unable to consume more than its total income plus its initial endowment." Consequently, "the 'fiscal deficit' would be equivalent to the dissaving (reduction in the net worth) of government in any year."

Robinson (left) and Stella: When a central bank makes a loss, the entire amount should be entered in the government's accounts.

Blejer and Cheasty describe what an ideal government balance sheet should include. They state that "to capture the complete array of ways in which a government can increase or run down its net worth in a global balance sheet, its assets should include financial assets; real capital (including nonmarketable social overhead capital and equity, which is mainly in public enterprises and is partly marketable); land and mineral assets (discovered and undiscovered, which are partly marketable); the present value of the future tax program (including social security contributions); and the imputed present value of seigniorage [the profit a country's government derives from printing and coining its money]. Liabilities should include government debt (domestic and foreign, indexed or not), the stock of high-powered money, and the present value of social insurance and other entitlement programs (including guarantees)."

They provide specific suggestions as to how a government might improve the accuracy of its accounts covering each of the major components of its assets and liabilities, noting that if a government follows this comprehensive approach to preparing its balance sheet, its total assets should actually equal its total liabilities *plus* its net worth.

Blejer and Cheasty conclude that "the jury is still out on whether net worth calculations of the deficit are superior to traditional flow measures." They note that, on the one hand, the net worth calculations whose use they advocate "correct for several blatant errors in treatment in currently accepted economic indicators"; on the other hand, "the [net worth] measures are not broad enough to internalize the indeterminancy created by the government's power to change the present value of tax and entitlement programs." They point out that net worth calculations are nonetheless quite broad measures of a country's long-term fiscal position and express the view that, consequently, analysts and policymakers should be cautious about using them as indicators for short-run fiscal policy.

Copies of *How to Measure the Fiscal Deficit* are available for US$22.50 each (399 pages, paperbound) from Publication Services, Box S-373, International Monetary Fund, Washington, D.C. 20431, U.S.A. (Telephone: (202) 623-7430; fax: (202) 623-7201.)

IMF ACTIVITIES

From The Executive Board . . .

Mongolia: Approval of ESAF. The IMF has approved a three-year loan for Mongolia equivalent to SDR 40.81 million (about $57 million) under the enhanced structural adjustment facility (ESAF) to support the country's economic and financial program for 1993–96. Mongolia may draw up to the equivalent of SDR 18.55 million (about $26 million) during the first year in support of its 1993–94 economic program. The ESAF loan follows an earlier IMF stand-by credit approved in 1991 for SDR 22.5 million (about US$31 million), which supported the country's 1991–92 economic program.

Following decades of relative isolation and dependence on the former Soviet Union, Mongolia initiated sweeping political and economic changes in 1990, including its transition to a market economy. These changes occurred against a background of severe external shocks, notably the breakup of the Council for Mutual Economic Assistance (CMEA) and its associated trading arrangements, and the virtual cessation of financial and technical assistance from the former U.S.S.R.

Declining prices for key exports and generally weak demand in convertible currency markets compounded the economic crisis. During 1991–92, under the IMF-supported economic program, progress was made in structural reform, but output declined steeply and inflation accelerated sharply, reflecting continued external difficulties and problems with policy implementation. These factors also contributed to sharp declines in net international reserves and the emergence of external arrears. In October 1992, the newly elected Government intensified its efforts to formulate and implement policies to address the economic crisis. A tightening of monetary and fiscal policies led to a significant reduction of the monthly inflation rate and to an improvement in Mongolia's external payments situation. In late May, additional measures were taken, including the adoption of a unified floating exchange rate system.

The medium-term economic program for 1993–96, which is supported by the ESAF, seeks average annual growth of GDP of 3.5 percent, a reduction in the annual rate of inflation to single digits by the end of 1995, and a strengthening of Mongolia's net international reserves. The medium-term strategy emphasizes strengthening macroeconomic management through the development of indirect instruments of monetary management and improvements in the financial and fiscal systems. At the same time, structural reforms are being reinforced to remove impediments to production and trade through further privatization, additional steps to develop the legal framework for a market economy, and measures to strengthen corporate governance.

In addition, the program contemplates completion of price liberalization and removal of the remaining restrictions imposed by the system of state orders and rationing. The ESAF arrangement is expected to catalyze significant amounts of donor assistance, continuing the strong donor support Mongolia has received since it began its economic transformation.

The program for mid-1993 through mid-1994, which the first annual ESAF loan supports, aims at arresting the decline in real GDP to below 2 percent in 1993 and attaining GDP growth of 2.5 percent in 1994; reducing the annual rate of inflation to less than 50 percent by June 1994; and building up Mongolia's net international reserves, as well as eliminating external payments arrears. To these ends, fiscal policy aims at a current account surplus of 2.3 percent of GDP in 1993 and 3.3 percent in 1994, through a combination of revenue measures and expenditure restraints. Monetary policy is designed to sharply reduce inflation while providing adequate credit to the productive sectors of the economy. The program envisages a flexible interest rate policy—with Bank of Mongolia lending rates and minimum commercial bank deposit rates to be maintained positive in real terms—and an exchange rate that will float freely in accordance with market conditions.

In the structural area, the program will build on policies already implemented by the authorities. In the external trade area, the emphasis will be on continuing to deregulate imports and exports and privatize state trading corporations, whose monopoly on external trade has been removed to allow an expanded role for the private sector. Foreign direct investment, a key element in the development of Mongolia's natural resources, will be fostered through new legislation liberalizing ownership. The program envisages broad-ranging financial sector reform to improve monetary management, enhance bank supervision, and strengthen financial intermediation, as well as measures designed to further privatization and reform of remaining state enterprises. A voucher privatization scheme, which accounts for some 45 percent of 1990 state enterprise assets, will be completed by the end of 1993. The authorities have also begun privatizing public buildings.

Mongolia joined the IMF on February 14, 1991. Its quota is SDR 37.10 million (about $51 million), and its outstanding financial obligations to the IMF cur-

SDR Rates

Week Beginning	Interest and Charges (percent)
July 19	4.53
July 26	4.59

The rate of SDR interest and charges is calculated weekly, by reference to a combined market interest rate, which is the weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). The interest rates used are those that prevail each Friday. For the latest weekly rate call (202) 623-7171.

Data: IMF Treasurer's Department

rently total the equivalent of SDR 13.75 million (about US$19 million).

Press Release No. 93/24, June 25

Dominican Republic: Stand-by Arrangement: The IMF has approved the use of its resources up to the equivalent of SDR 66.4 million (about $92 million) by the Dominican Republic. Of this total, up to SDR 31.8 million (about $44 million) may be drawn over the next eight months under a stand-by credit to support the Government's financial and economic program for 1993. An additional amount equivalent to SDR 34.6 million (about $48 million) is available immediately under the compensatory and contingency financing facility (CCFF) to cover a shortfall in merchandise export receipts. Today's action follows the Dominican Republic's successful implementation of its 19-month economic program, which was supported by an IMF stand-by credit that expired on March 27, 1993.

The Government's 1993 economic program aims at real GDP growth of about 5 percent, an annual rate of inflation in the range of 5-8 percent, and a further strengthening of the country's net international reserves. To achieve these objectives, the program seeks to maintain external competitiveness and consolidate a sound fiscal position. In this context, the 1993 program calls for a balanced public sector position (following small surpluses in the previous two years) while allowing for a moderate increase in public investment spending, consistent with the path of fiscal adjustment drawn up for the medium term. Monetary policy will underpin the program's inflation and balance of payments objectives while allowing for a substantial increase in banking system credit to the private sector. The authorities intend to continue pursuing prudent wage policies. Also envisioned are the completion of the external debt-restructuring process, continued implementation of trade and tax reforms, the introduction of financial system reform, and a program to strengthen tax administration.

To improve the efficiency of the financial sector, the authorities have drafted a financial and monetary reform designed to increase competition among institutions and strengthen the Central Bank's autonomy in conducting monetary policy. The reform, which is expected to receive support from multilateral development banks, will also provide for the use of market-based policy instruments, tighten pruden-

Stand-By, Extended, Structural Adjustment Facility (SAF), and Enhanced Structural Adjustment Facility (ESAF) Arrangements as of June 30, 1993

(million SDRs)

Member	Date of Arrangement	Expiration Date	Amount Agreed	Undrawn Balance
Stand-by arrangements			**2,587.49**	**2,220.70**
Albania	August 26, 1992	August 25, 1993	20.00	6.88
Brazil	January 29, 1992	August 31, 1993	1,500.00	1,372.50
Costa Rica	April 19, 1993	February 18, 1994	21.04	21.04
Czech Republic	March 17, 1993	March 16, 1994	177.00	107.00
El Salvador	May 10, 1993	March 9, 1994	34.55	34.55
Estonia	September 16, 1992	September 15, 1993	27.90	15.11
Guatemala	December 18, 1992	March 17, 1994	54.00	54.00
Jordan	February 26,1992	August 25, 1993	44.40	11.10
Kyrgyzstan	May 12, 1993	April 11, 1994	27.09	17.42
Latvia	September 14, 1992	September 13, 1993	54.90	19.83
Lithuania	October 21, 1992	September 20, 1993	56.93	26.45
Panama	February 24, 1992	December 23, 1993	93.68	58.83
Poland	March 8, 1993	March 7, 1994	476.00	476.00
Extended arrangements			**4,838.98**	**2,261.99**
Argentina	March 31, 1992	March 30, 1995	2,483.15	1,182.16
Hungary	February 20, 1991	February 19, 1994	1,114.00	556.77
Jamaica	December 11, 1992	December 10, 1995	109.13	81.75
Peru	March 18, 1993	March 17, 1996	1,018.10	375.41
Zimbabwe	September 11, 1992	September 10, 1995	114.60	65.90
SAF arrangements			**83.23**	**59.45**
Comoros	June 21, 1991	June 20, 1994	3.15	2.25
Ethiopia	October 28, 1992	October 27, 1995	49.42	35.30
Rwanda	April 24, 1991	April 23, 1994	30.66	21.90
ESAF arrangements			**2,167.29**	**792.41**
Bangladesh	August 10, 1990	September 13, 1993	345.00	–
Benin	January 25, 1993	January 24, 1996	46.95	39.12
Bolivia	July 27, 1988	September 10, 1993	163.26	13.61
Burkina Faso	March 31, 1993	March 30, 1996	48.62	39.78
Burundi	November 13, 1991	November 12, 1994	42.70	23.49
Equatorial Guinea	February 3, 1992	February 2, 1996	12.88	10.12
Guinea	November 6, 1991	November 5, 1994	57.90	40.53
Guyana	July 13, 1990	December 20, 1993	81.52	8.86
Honduras	July 24, 1992	July 23, 1995	40.68	33.90
Lao P.D.R.	June 4, 1993	June 3, 1996	35.19	29.33
Lesotho	May 22, 1991	May 21, 1994	18.12	7.55
Malawi	July 15, 1988	July 15, 1993	66.96	5.58
Mali	August 28, 1992	August 27, 1995	60.96	40.64
Mauritania	December 9, 1992	December 8, 1994	33.90	25.43
Mongolia	June 25, 1993	June 24, 1996	40.81	31.54
Mozambique	June 1, 1990	September 30, 1993	100.65	15.25
Nepal	October 5, 1992	October 4, 1995	33.57	27.96
Sri Lanka	September 13, 1991	September 12, 1994	336.00	168.00
Tanzania	July 29, 1991	July 28, 1994	181.90	96.30
Uganda	April 17, 1989	November 24, 1993	219.12	19.92
Zimbabwe	September 11, 1992	September 10, 1995	200.60	115.50
TOTAL			**9,676.98**	**5,334.55**

Note: Figures may not add to totals because of rounding.

Data: IMF Treasurer's Department

tial regulations, and strengthen banking supervision.

The funds provided under the CCFF will help compensate the Dominican Republic for a temporary shortfall in export earnings from ferronickel, gold, raw sugar, cocoa beans, and coffee during the 12 months that ended March 1993. The shortfall is in large part due to a weakening of world market prices.

The Dominican authorities have successfully pursued a comprehensive economic program of adjustment and structural reform since 1990, after a period of widening economic imbalances. Public finances shifted from a deficit of 5 percent of GDP in 1990 to a surplus of over 1.5 percent of GDP two years later, and major structural reforms were implemented, including the unification and liberalization of the exchange rate system, decontrol of exchange and interest rates, introduction of realistic public sector pricing policies, lifting of price controls, and initiation of a trade reform. A new labor code was also adopted, and an important tax reform was introduced in 1992. As a result, the annual rate of inflation has been brought under control and now stands at single-digit levels; economic growth has resumed, with real GDP rising by 7 percent last year; and international reserves have been strengthened considerably.

The Dominican Republic is an original member of the IMF, and its quota is SDR 158.8 million (about $221 million). Its outstanding financial obligations to the IMF resulting from past operations and transactions currently total the equivalent of SDR 86.1 million (about $120 million).

Press Release No. 93/26, July 9

Currency Units per SDR

Currency	JUNE 16	17	18	21	22	23	24	25	28	29
Deutsche mark	2.32612	2.33093	2.3405	2.34525	2.34535	2.36018	2.37116	2.39049	2.39	2.3713
French franc	7.83084	7.85862	7.88479	7.87342	7.8962	7.92984	7.98135	8.01696	8.04329	7.97606
Japanese yen	149.892	150.856	150.882	153.406	154.739	153.816	150.73	150.052	147.804	148.302
Pound sterling	0.953839	0.939995	0.931294	0.935815	0.933685	0.942363	0.944496	0.946290	0.939356	0.95614
U.S. dollar	1.41487	1.40987	1.40486	1.39641	1.39091	1.38573	1.38794	1.39389	1.39701	1.39513
Argentine peso	...	...	...	...	...	...	...	...	...	...
Australian dollar	2.08699	2.0813	2.08405	2.04425	2.02964	2.02918	2.07032	2.07486	2.09099	2.08902
Austrian schilling	16.3623	16.4264	16.479	16.4927	16.4962	16.601	16.6898	16.7587	16.8354	16.6592
Bahrain dinar	0.531879	0.530111	0.528227	0.52129	0.522982	0.521034	0.521865	0.524103	0.525276	0.524589
Bangladesh taka	56.2999	56.1128	55.9134	55.1791	55.3582	55.1521	55.24	55.4768	55.601	55.5262
Belgian franc	47.816	47.9603	48.0482	48.1673	48.2159	48.3689	48.7818	48.8001	49.1822	48.8482
Brazilian cruzeiro	67086.2	67699.1	68312.7	68255.7	69302.7	69827.1	70918.8	72090.6	73140.5	73950.3
Canadian dollar	1.81065	1.80026	1.79062	1.78569	1.77772	1.77443	1.77989	1.78794	1.79139	1.7873
Colombian peso	1215.16	1211.61	1207.91	...	1196.59	1192.74	1195.34	1201.03	1204.32	1203.24
Danish krone	8.89067	8.90448	8.94404	8.97007	8.96369	9.01279	9.09378	9.10489	9.18115	9.09206
Finnish markka	7.82781	7.88339	7.84825	7.84902	7.82874	7.84228	7.98152	...	8.03937	7.96103
Greek drachma	316.567	317.776	318.461	318.888	319.562	320.977	323.223	324.275	325.783	322.631
Indian rupee	44.4741	44.3098	44.1686	43.8867	43.6328	43.4704	43.5367	43.7283	43.8382	43.7852
Indonesian rupiah	2948.55	2938.17	2929.13	2890.66	2902.83	2892.02	2896.83	2910.44	2916.96	2913.03
Iranian rial	2297.26	2286.83	...	2244.8	2242.15	2233.8	2237.36	2246.95	2251.96	2248.96
Iraqi dinar	0.439729	0.438398	0.436711	0.430976	0.432375	0.430764	0.431451	0.433301	0.434271	0.433686
Irish pound	0.953957	0.957337	0.957579	0.959254	0.961702	0.968089	0.971639	0.975226	0.978387	0.97083
Italian lira	2114.15	2120.08	2121.03	2122.39	2121.94	2125.97	2137.77	2148.14	2170.3	2183.38
Korean won	1134.48	1130.57	1128.7	1112.18	1117.46	1114.4	1114.79	1118.74	1121.86	1121.41
Kuwaiti dinar	0.425375	0.4243	...	...	0.419628	0.417984	0.418353	...	0.420835	0.420269
Libyan dinar	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286
Malaysian ringgit	3.63441	3.61702	3.61218	...	3.60178	3.5871	3.58394	3.60599	3.60848	3.60082
Maltese lira	0.534607	0.536602	0.532991	0.533542	0.53546	0.537063	0.53905	0.540634	0.542982	...
Nepalese rupee	89.9534	89.422	89.1994	88.2807	88.5023	88.2472	88.366	88.6491	88.7888	88.6962
Netherlands guilder	2.6113	2.62206	2.62257	2.62739	2.63438	2.64619	2.66054	2.66958	2.67949	2.66501
New Zealand dollar	2.8051	2.59662	2.59056	2.58315	2.5729	2.56807	2.57407	2.59822	2.59957	2.59807
Norwegian krone	9.82686	9.86862	9.86362	9.89411	9.90397	9.93638	10.0119	10.0235	10.1046	9.9875
Omani rial	0.543902	0.542096	0.540189	0.533075	0.534806	0.532813	0.533963	0.536951	0.53715	0.536427
Pakistan rupee	38.3456	38.3031	38.167	37.8857	37.798	37.6472	37.7073	37.8889	38.0376	37.9886
Portuguese escudo	221.271	222.326	222.806	222.639	221.927	223.043	224.745	226.224	228.19	226.295
Qatar riyal	5.14903	5.13193	5.11369	5.04653	5.06291	5.04408	5.0621	5.07376	5.08512	5.07827
Saudi Arabian riyal	5.29758	5.27996	5.2612	5.19211	5.20698	5.18958	5.19784	5.22012	5.2318	5.22478
Singapore dollar	2.27944	2.27722	2.27152	2.26064	2.26109	2.25941	2.2561	2.26829	2.26948	2.26318
South African rand	4.58279	4.59036	4.54829	4.55782	4.5754	4.57499	4.60102	4.62254	4.64855	4.64648
Spanish peseta	177.91	178.757	178.726	179.013	179.066	179.954	180.987	182.084	182.911	181.118
Sri Lanka rupee	66.1469	67.9983	67.7311	66.9609	67.2296	67.0174	67.1451	67.4309	67.6174	67.5081
Swedish krona	10.3788	10.4986	10.5084	10.5076	10.5215	10.571	10.8509	...	11.0077	10.8457
Swiss franc	2.07859	2.08581	2.08822	2.08585	2.08706	2.09758	2.1055	2.11732	2.11847	2.10995
Thai baht	35.5764	35.5428	35.4306	35.1039	35.2586	35.1421	35.1149	35.2935	35.2466	35.227
Trinidad and Tobago dollar	8.09982	8.09222	8.00541	7.89627	...	7.88457	...	7.95878	7.96884	7.948
U.A.E. dirham	5.19289	5.17593	5.15724	5.08961	5.10603	5.08701	5.09513	5.11897	5.12942	5.12152
Venezuelan bolivar	125.755	125.478	125.243	123.737	124.347	...	...	124.983	...	...

Notes: 1. The value of U.S. dollar in terms of the SDR is the reciprocal of the sum of the dollar values, based on market exchange rates, of specified quantities of the first five currencies shown. The exchange rates used for this purpose are noon rates in the London foreign exchange market. When the London market is closed, noon rates in the New York market are used. Frankfurt fixing rates are used when the New York market is closed. 2. The value in terms of the SDR of each of the other currencies shown above is derived from that currency's representative exchange rate against the U.S. dollar as reported by the issuing central bank and the SDR value of the U.S. dollar, except for the Iranian rial and the Libyan dinar, the values of which are officially expressed directly in terms of the domestic currency units per SDR.

Data: IMF Treasurer's Department

Seminar Examines Economies in Transition

(continued from front page) lower income levels from the initial shocks that inevitably accompany reform. As Keyoung Chu, Assistant Director for the Expenditure Policy Division, explained, "The reform will eventually help the poor as the economy grows, but in the short term during the transition, some of the measures that are designed to help the poor in the long run will actually have a negative impact." Therefore, an important element in any reform process is the social safety net, which Chu defined as "any social policy measures aimed at mitigating the short-run adverse effect of reform measures on the poor."

Unless these social measures are incorporated into the reform program, some of the poor are inevitably going to get hurt in the transition period. If governments hope to sell their programs to the public, Chu said, they have to include these measures. "The social safety nets themselves," he said, "will strengthen the political viability of the program."

Although Chu's main focus was on the reform process in Russia, many elements of the reform process—and their effect on the poor—were common to the 15 countries that emerged from the breakup of the former Soviet Union.

Most of these states inherited a "standard mix of social policy instruments," according to Chu. Of these, subsidies are important. The prices of many essential commodities—such as food and energy—continue to be maintained at low levels, and the result is a distorted price structure.

Although subsidies provide protection for the poor, they are inefficient because, as Chu pointed out, they are "delivered in the form of price controls and thus afford the same protection to the wealthy and middle classes." Moreover, as controls are loosened, prices rise toward market-clearing levels—with negative consequences for the poor, unless their nominal income also catches up.

Other available social policy instruments include pensions, family allowances, and social insurance funds for maternity and sickness benefits. In addition, many of these countries have recently introduced unemployment compensation and retraining schemes.

A major problem facing policymakers is how to continue financing these social programs, many of which are costly. The question, said Chu, is "how to reduce their cost but make them more effective in helping the poor."

For instance, subsidies should not be generalized, but should be targeted to the groups that need them the most. According to Chu, standard groups among the countries of the former Soviet Union that would be most affected by the short-term effects of the reform include (1) the unemployed; (2) the underemployed—a substantial number of workers who, according to Chu, are not laid off, but are "sent off on unpaid vacations"; (3) the working poor, caught in the trap of rising food prices and lagging nominal wages; (4) pensioners, many of whom receive minimum pensions; (5) families with a large number of children; and (6) people living in urban areas or in rural areas who are net consumers of certain commodities—like food—whose prices are rising.

A difficult task is to design a safety net that addresses each country's specific needs. In Russia, for example, pensioners are a particularly vulnerable group. Russia's population is older than that of other countries of the former U.S.S.R., but its retirees are younger because people begin to retire at age 55. Russia also covers a vast territory, and its total population tops 150 million. Prices cannot be equalized across such a geographically wide area, which is fragmented by inadequate transportation. Local governments may need to assume administrative roles; nevertheless, according to Chu, "the central Government has to play a role in ensuring that some basic uniform benefits are distributed country-wide."

Reform in Poland

"Eastern Europe was taken by storm sometime in late 1989," according to Gandhi, and Poland was among the first countries to feel the brunt of the storm and to begin the process of transition to a market economy. According to Gandhi, the prereform Polish economy provided a textbook example of centrally planned economies.

The tax ratio was relatively high (about 45–50 percent of GDP) but not, according to Gandhi, exceptionally high. One of the reasons it was high, he said, was that, as in other transition economies, "the enterprises were the main milking cows for the Government's revenue-raising efforts." High turnover taxes and enterprise income taxes accounted for almost 80 percent of the total tax revenue in Poland in the prereform years. The tax ratio was also characterized by a highly discretionary application of the tax system.

Prereform Poland provided large subsidies to consumers in the form of transportation, housing, and fuel, as well as to producers, and exporters—a total of 16 percent of GDP in 1989. In contrast, wages and salaries were kept low—4 percent of GDP in 1989—in conformance with the country's incomes policies.

Capital expenditures were also low—3 percent of GDP—because the state-owned enterprises, not the government budget, were the main vehicle of capital expenditure investment. As in other centrally planned economies, the socialized enterprises played a large role in Poland. Their share in total investment was 80 percent (20 percent of GDP), and their industrial output accounted for 90 percent of the total. Tax relief was available to those enterprises experiencing financial difficulties, and subsidies were high—14 percent of GDP.

Gandhi identified two areas that needed immediate action in the fiscal reform effort, which began in November 1989.

• ***A Tax System and the Rule of Tax Law.*** Although the tax ratio, at 45 percent of GDP, was not excessively high when compared with many European and Scandinavian countries, Gandhi said it was too high to instill confidence in the private sector and, ideally, should be lowered to about 25 percent or 30 percent of GDP.

To accomplish such a reduction without imposing social security taxes, Poland would need to include four elements in its tax reform: (1) a global personal income tax indexed, to the extent possible, to inflation; (2) an enterprise income tax with no provisions for tax relief or tax incentives or allowances for discretionary application; (3) a broad-based consumption tax, preferably in the form of a value-added tax (VAT); and (4) an excise duty system on a handful of items but at relatively high rates.

• ***Proper Budgetary System.*** Subsidies accounted for a major portion of public expenditures, and it was obvious, said Gandhi, that they would have to be curtailed. The liberalization of prices meant that consumer subsidies would have to be cut, and, he noted, "producer subsidies would either have to be removed or at least made more transparent." Although total wages and salaries would fall as the Government began to disengage itself from direct production activity, average salaries might have to increase to account for inflation.

Capital expenditures on economic and social infrastructure would have to increase substantially to support private sector development. Further, related systems and programs needed to be set up and, where applicable, financed. Among them, according to Gandhi, are "a proper public debt-management policy, an appropriate income support system, a social safety net system, a budgetary control system, and a proper decentralization and restructuring of intergovernmental fiscal relations."

Gandhi: It is easy to nationalize; it is not easy to denationalize.

Finally, the socialized enterprises had to be privatized or allowed to go bankrupt. "At the least," said Gandhi, "they had to be made to face hard budget constraints, including an end to indirect subsidies through bank credit or preferential exchange rates for imports."

Poland has made considerable progress in implementing elements of the fiscal reform package that Gandhi outlined, including a global income tax, an enterprise income tax (at a 40 percent rate, but somewhat weakened by tax preferences), and several excise duties. The Government has recently passed a VAT, but implementation may take some time because, according to Gandhi, "the administrative preparedness is lacking."

Progress has been made in expenditure policy as well, with sharp reductions in consumer and producer subsidies (from 16 percent of GDP in 1988 to 5 percent in 1991 and about 4 percent in 1992). However, some subsidies are still in place for housing loans and housing construction loans.

Privatization continues to lag behind the other reforms, owing, according to Gandhi, to a lack of clear-cut property rights and uncertainty on the part of the enterprises. Institution building has also been difficult, particularly in the areas of tax administration and budgetary control processes.

"It is easy to nationalize," Gandhi said; "it is not easy to denationalize." The Polish economy had made "amazingly substantial, if uneven, progress," and the unevenness did not, he said, reflect lack of will power but rather the nature of the problems and the "political realities, which the politicians cannot ignore."

Transition Versus Transformation

Reforming governments would do well, according to Parthasarathi Shome, Chief of the Tax Policy Division, to heed the distinction between "transition" and "transformation." "Very often," he said, "we speak of the ideal tax structure or the ideal expenditure structure—where we want to go." However, the interim period can be characterized by potentially dangerous macroeconomic instability and calls for appropriate interim measures. In the reforming economies of the former U.S.S.R., said Shome, as controls are clamped on expenditures and output declines, almost invariably in the short transitory phase revenues decline faster than

expenditures—that is, it takes longer to put the brakes on expenditures than it does to stop the free fall in revenues.

The result is an expanding fiscal gap, and, according to Shome, "the primary concern—at least in this short interim phase—should be how to close this gap in the face of high inflation that often reaches 25–30 percent a month." Several states of the former U.S.S.R. have experienced these potentially destabilizing gaps: the deficit in Kazakhstan, for example, shot up from zero in 1988 to 8 percent of GDP in 1989; Kyrgyzstan and other central Asian states had similar experiences.

Given the macroeconomic problems that can arise from a big fiscal gap, Shome suggested that, in the short run, policymakers "should not worry too much about efficiency in resource allocation—the ultimate end—but should turn to such measures as turnover taxes to close the gap." In Kazakhstan, for example, the authorities were able to reduce the fiscal deficit from 8 percent to 6 percent of GDP by 1992.

Another important element of economic transformation—privatization—may also require interim measures, according to Shome. The government cannot simply privatize and get out, he said, leaving the newly created private sector to develop on its own, without assets or direction. Shome suggested that governments might consider exercising "selected guidance," a strategy pursued with considerable success by postwar Japan and some of the other East Asian economies, such as Singapore, Korea, and Taiwan Province of China. In a situation of slow or even negative growth and tremendous asset losses, the postwar Japanese Government selected certain sectors, such as steel, that would support the economy as the big monopolies were being broken up. The breakup of the Japanese monopolies—which by the end of the war had been in operation for one hundred years or so—was, said Shome, comparable to the privatization of the state-owned enterprises in the countries of the former U.S.S.R. In Kazakhstan, for example, the Government could profitably support such infrastructural sectors as steel, energy, and electricity. In time, as the private sector developed and grew, it could take over the sectors being supported by the Government, whose presence could gradually recede.

Shome: The optimal tax structure cannot come tomorrow.

The lesson to be learned, Shome concluded, is that "the optimal tax structure or expenditure structure cannot come tomorrow." Therefore, to keep the economy from falling apart before it can reap the benefits of the reform, policymakers should be prepared to close the short-term gaps.

Viet Nam's Experience

In 1989, the Government of Viet Nam launched a comprehensive economic adjustment program. According to Howell H. Zee, Deputy Division Chief of the Tax Policy Division, the Vietnamese experience was both similar to and different from that of other comparable countries undergoing transformation.

The similarities were, according to Zee, "all related to the institutional constraints that a country undertaking a comprehensive reform program would typically face."

• ***Privatization.*** Privatization of the state-owned enterprises posed the most difficult problems. The difficulties arose from the lack of an adequate legal framework, as well as from a reluctance on the part of the Government to close down nonviable enterprises. As Zee said, "By closing the enterprises, the Government was going to throw a lot of people out of work, and that would create problems."

• ***Underdeveloped Financial Markets and Banking System.*** Viet Nam also shared with other transition countries difficulties in reforming and developing its financial markets and banking system. In a centrally planned economy, monetary policy plays a subservient role to the central plan, so that, as Zee pointed out, "the central bank does not have at its disposal instruments sufficient to conduct sound monetary policies in a market-oriented environment." A CPE thus does not have the mature financial market needed to intermediate financial flows. According to Zee, Viet Nam had experienced great difficulty in carrying out a successful reform of the financial sector.

• ***Tax Reform.*** Like other centrally planned economies, Viet Nam had used its tax system largely to transfer resources among different sectors at the direction of the central Government under the central plan. Policymakers encountered considerable difficulty in attempting to turn the tax system into one that was more compatible with a market-oriented economy.

The major differences between the experience of Viet Nam and other comparable economies were, according to Zee, "all related to various aspects of Viet Nam's macroeconomic

performance." Over the entire two-and-a-half year period, Viet Nam suffered no output loss; in fact, GDP grew at an average rate of about 6–8 percent a year. Second, Viet Nam did not suffer any significant balance of payments shock. And third, during the entire period, the budget did not run up any significant deficits. Even inflation, which was running at over 300 percent in 1988, fell somewhat, to 50–60 percent during the period.

Moreover, Viet Nam racked up this impressive performance despite trade restrictions imposed by the West and the former Soviet Union's abrupt withdrawal in 1990 of most of its financial support. "How", asked Zee, "did Viet Nam manage such a feat when most other countries failed?" He pointed to three conditions peculiar to the Vietnamese economy that provided a cushion against reform-induced macroeconomic shocks.

• ***Agriculture-Based Economy.*** With over 40 percent of its GDP coming from the agricultural sector, Viet Nam was and, by and large, still is an agriculture-based economy. Agricultural reforms preceded all the others, and their success, according to Zee, can be summed up in the often-quoted statistic, "Viet Nam transformed itself over a period of two years from a rice importer to the world's second or third largest rice exporter."

• ***Parallel State and Nonstate Sectors.*** Unlike many other economies in transition, in Viet Nam a sizable nonstate sector consisting of light consumer industrial goods and services has operated in parallel with the state sector. The state sector, compared with other similar economies, is relatively small.

Zee: Viet Nam transformed itself from a rice importer to the world's second or third largest rice exporter.

• ***Crude Oil Production.*** In 1989 Viet Nam began producing significant amounts of crude oil. According to Zee, this third cushioning factor was and continues to be the most important, earning hard currency and keeping the budget well supplied with necessary revenues. Crude oil earnings insulated the economy from the adverse effects on the balance of payments occasioned by the collapse of the Council for Mutual Economic Assistance (CMEA) system, as well as from the financial difficulties of the state-owned enterprises.

Despite the conspicuous success of Viet Nam's reform program, Zee said the economy still faces some pitfalls "down the road." In his opinion, the Government should be using the tax system to generate revenues in a neutral manner, rather than primarily as a tool for directing economic resources. Second, the Government should resist the temptation to prop up nonviable state-owned enterprises with soft banking loans and other implicit and indirect financial subsidies. Finally, Zee said, in the interests of economic integration between the north and the south, Viet Nam "has to recognize the need for increased spending on infrastructure, particularly in transportation."

Finally, Zee suggested that planners may wish to view a comprehensive economic reform program as "an investment project on the grand scale." The willingness to undertake such a project, he said, implies confidence that the present value of the project is positive. If so, then planners should be willing "to live with some deficits in the initial stages—be they trade or budget deficits—so long as they do not threaten the overall stability of the economy in the long run."

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